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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

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January 31, 2000

The Honorable William Kennard
Chairman
Federal Communications Commission
445 12th Street, S.W.
Washington, D.C. 20554

Re: Coalition for Affordable Local and Long Distance Services; CC Docket Nos. 96-262, 94-1, 99-249, and 96-45

Dear Chairman Kennard:

AARP appreciates the opportunity to submit a compromise proposal for incorporation into the Coalition for Affordable Local and Long Distance Services (CALLS) petition filed with the Federal Communications Commission (FCC) on July 29, 1999. AARP joined with the Texas Office of Public Utility Counsel, the Consumer Federation of America, Consumers Union, the National Association of State Utility Consumer Advocates, the International Communications Association and the National Retail Federation in developing the attached compromise proposal.

In comments submitted to the FCC on November 12, 1999, AARP expressed opposition to the CALLS petition. The concerns we expressed centered around the lack of benefits residential consumers would realize. AARP believes that the attached compromise proposal, if adopted, will bring immediate benefits to consumers via reductions in the cost of telephone service, regardless of long distance usage, while providing carriers with most of the relief they have sought.

AARP urges the Commission to incorporate this compromise proposal into the existing CALLS petition. Implementation of this proposal will go a long way towards resolving the cost issues facing the Commission, will assist the carriers and most importantly, will provide consumers with real, clearly identifiable benefits in the form of lower costs.

Sincerely,

Martin Corry

Martin A. Corry
Director
Federal Affairs

601 E Street, NW Washington, DC 20049 (202) 434-2277 www.aarp.org


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# CONSUMER GROUP PROPOSAL TO RESTRUCTURE FEDERAL COST RECOVERY AND SETTLE OUTSTANDING ACCESS CHARGE ISSUES

**Supported By**

**TEXAS OFFICE OF PUBLIC UTILITY COUNSEL, CONSUMER FEDERATION OF AMERICA, CONSUMERS UNION, NATIONAL ASSOCIATION OF STATE UTILITY CONSUMER ADVOCATES, AARP, NATIONAL RETAIL FEDERATION, INTERNATIONAL COMMUNICATIONS ASSOCIATION**

January 31, 2000

## INTRODUCTION: COMPROMISE CONSUMER RESPONSE TO THE CALLS PLAN

The following plan has been endorsed by a number of consumer groups and should be incorporated into the Coalition for Affordable Local and Long Distance Services (CALLS) petition before the Federal Communications Commission (FCC) so that consumer benefit, currently absent from the proposal, may be realized.

The undersigned groups have been concerned from the outset that CALLS provides no tangible benefits for consumers. We are confident that this compromise proposal will bring immediate benefits to consumers via reductions in the cost of telephone service. These reductions in the cost of service will appear on a consumer's bill from the outset regardless of long distance usage. The plan we outline would allow consumers to reap several billion dollars in benefits.

Recognizing that the manner in which revenues are collected in the federal jurisdiction is of utmost importance to the proponents of the CALLS proposal, we have tried to devise a methodology that will enable costs to be recovered without unduly discriminating against any class of customers (residential or business) or segment of the industry (local exchange companies or the long distance carriers). In doing so, the undersigned groups have offered relief to the carriers in many of the areas that precipitated the initiation of the CALLS petition.

On the other hand, the consumer proposal requires the two segments of the industry to each shoulder part of this financial responsibility. Business and residential customers get the same reductions in their fixed charges, under the consumer proposal. Fixed charges and usage charges are reduced equally.

## CONSUMER COMPROMISE PLAN ELEMENTS

Business-as-usual (BAU) assumptions produce reductions in cost recovery in the Federal jurisdiction of over $5 billion over five years. Therefore, we are addressing only changes in timing and "new" moneys needed to affect a compromise that restructures federal cost recovery.

## CONSUMERS GET UP FRONT BENEFIT

| | |
|---|---|
| **1. SUBSCRIBER LINE CHARGE (SLC)**<br>Reduce all SLCs by $1.00/mo. | $2.0 billion |
| **2. PRIMARY INTEREXCHANGE CARRIER CHARGE (PICC)**<br>Remove all PICCs entirely from consumers' bills.<br>(IXCs responsible for $.50 payment). | 1.8 |
| **3. SPECIAL ACCESS** | .2 |
| **Total Reductions in ILEC Revenue before 7/1/00 (next BAU change)** | 4.0 |

## IXC'S GET

**4. SWITCHED ACCESS**

Lower Switched Access to $.0055 over 4 years.
(This is funded by the continued use of the X-Factor).

**5. PICC**

Reduced to $.50.

**6. NO IMMEDIATE INCREASE IN UNIVERAL SERVICE FUND COLLECTIONS**

No new universal service charge of $650 million.

## ILECS GET

**7. PRODUCTIVITY FACTOR**

Keep the X-factor at 6.5% and use reductions to move switching rates to $.0055. When switching rates equal $.0055, the productivity factor is eliminated. At the end of the transition period, switching rates, SLC and PICC charges are capped at then current levels and presumed to be just and reasonable by the operation of market forces. Parties may seek to change the cap but bear the burden of making two showings: (1) demonstration of market failure and (2) economic cost model adopted by FCC supports the requested change. Movant has the burden of proof.

**8. AUDIT:**

The audit is settled with no further actions required other than the implementation of the reductions and productivity factor discussed above.

**BACK UP CALCULATION AND COMPARISONS OF THE ENDPOINT OF RESTRUCTURING OF COST RECOVERY IN THE FEDERAL JURISDICTION.**

The up front reduction of charges in the consumer plan comes before, but within the business-as-usual assumptions. Thus, two factors will be at work in restructuring the cost recovery in the federal jurisdiction. It is important to keep the two separate and to understand how they interact to produce the end point that is desired (see Exhibit 1). It is also important to keep the short term, up front reductions and long-term final rate structure in view. The interactions between these effects are important to recognize.

EXHIBIT 1
COMPARISON OF CURRENT RULES, CALLS AND CONSUMER ALTERNATIVE
(Aggregate Collection from all Consumers in $ Billions)

| | 7/1/99 | | 7/1/00 | 7/1/04 | DIFFERENCE 7/1/99-7/1/04 |
|---|---|---|---|---|---|
| CURRENT RULES | | | | | |
| PICC | 2.83 | | 2.66 | 1.52 | -1.31 |
| SLC | 9.28 | | 9.32 | 8.37 | - .91 |
| SPECIAL | 5.28 | | 5.28 | 4.06 | -1.22 |
| SWITCHED | 5.96 | | 5.20 | 4.03 | -1.93 |
| TOTAL | 23.35 | | 22.46 | 17.98 | -5.37 |
| CALLS | | | | | |
| PICC | 2.83 | | .53 | .03 | -2.80 |
| SLC | 9.28 | | 12.44 | 13.06 | +3.78 |
| SPECIAL | 5.28 | | 5.13 | 5.13 | - .15 |
| SWITCHED | 5.96 | | 3.74 | 3.20 | -2.76 |
| TOTAL | 23.35 | | 21.84 | 21.42 | -1.93 |
| CONSUMER | UP FRONT REDUCTION | | | | |
| PICC | 2.83 | -1.80 | 1.03 | 1.03 | -1.80 |
| SLC | 9.28 | -2.00 | 7.28 | 7.28 | -2.00 |
| SPECIAL | 5.28 | - .20 | 5.08 | 4.06 | -1.22 |
| SWITCHED | 5.96 | | 5.20 | 3.20 | -2.76 |
| TOTAL | 23.35 | | 18.59 | 15.54 | -7.78 |

For example, under the current rules, there will be a total reduction of $5.37 billion. Although the consumer proposal makes a $4 billion reduction up front, the total reduction is not $9.37 billion because the productivity factor in the out years is applied to a smaller base. The total reduction necessary to restructure cost recovery in the federal jurisdiction is equal to a total of $7.78 billion. Therefore, the consumer plan requires just under $2.5 billion in new reductions in cost recovery above the base case.

Exhibit 1 shows the recovery of costs in the four categories the consumer proposal affects. The numbers for current rules and CALLS were presented by MCI to the Commission. They are a true representation of the CALLS assumptions. The CALLS Coalition appears to be backing off of its own assumptions since this analysis shows that the CALLS proposal is not revenue neutral; it is obvious that all else equal, CALLS cannot be revenue neutral since it lowers the productivity factor and therefore foregoes rate reductions.

In addition to the up front reductions, there is one other substantial difference between the consumer approach and the CALLS approach. This analysis focuses only on the interstate revenues and does not include any changes in universal service fund payments. In particular, the consumer proposal moves switched access to $.0055 per minute without creating a new universal fund (arbitrarily set at $650 million by CALLS). To the extent that such an accounting item (i.e. implicit subsidy) is necessary, it should be accounted for in settling the audit. We recognize that universal service funds for high cost support will be necessary, but CALLS did not address this issue.

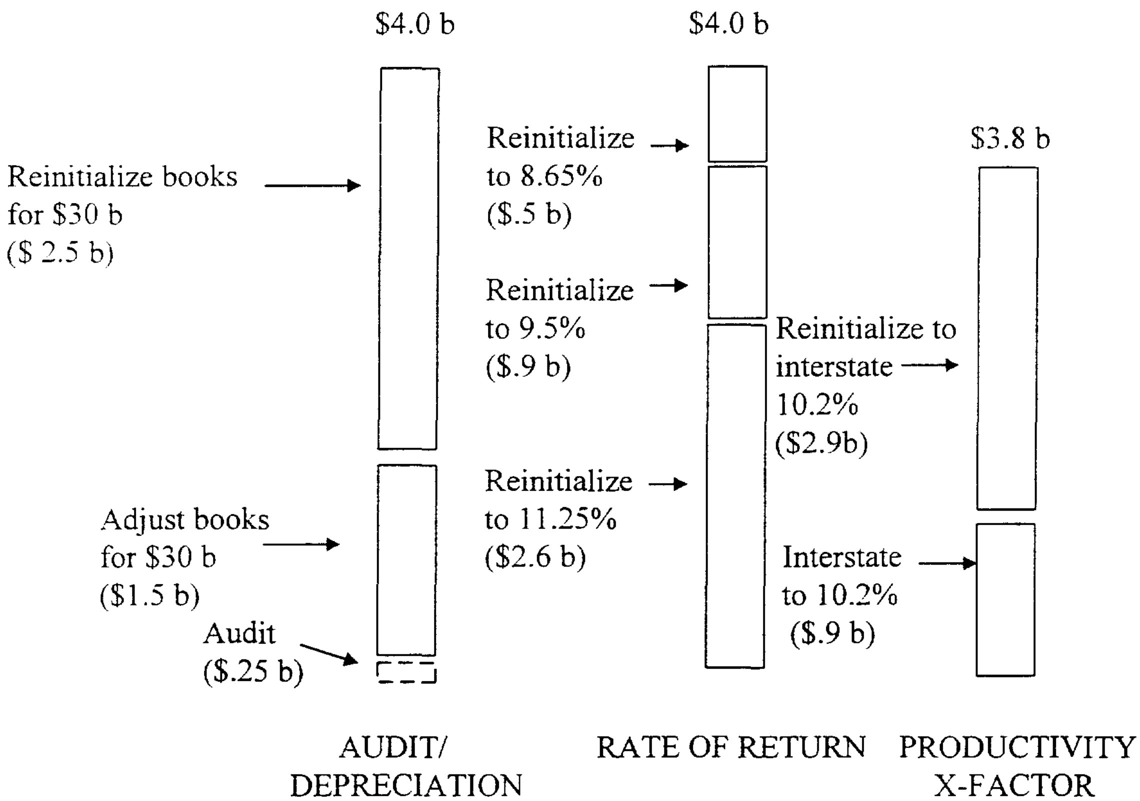
## OVER RECOVERY OF COSTS IN THE FEDERAL JURISDICTION IDENTIFIED IN ONGOING PROCEEDINGS

Year-after-year, when the local exchange companies report their earnings in the Federal jurisdiction, they are far above the targeted level. As demonstrated in several proceedings at the FCC, this over recovery arises because the Commission has not established sufficiently productivity goals or held the local company books up to rigorous scrutiny (see Exhibit 2). The reform of rates under the consumer plan is funded by eliminating the over recovery of costs in the Federal jurisdiction.

The audit has found phantom assets and the FCC has noted that the RBOCs report far more assets to regulators than they carry on their financial books. This raises cost recovery far in excess of where it should be. For example, the audit yielded a discrepancy of $5 billion, which would generate cost recovery reductions of about $.25 billion in the federal jurisdiction. Reconciling the depreciation discrepancy between financial and regulatory books would increase the total reductions in cost recovery dramatically -- some $1.5 billion. Reinitializing rates would result in another $2.5 billion reduction.

The FCC uses a company-wide productivity factor, rather than an interstate specific productivity factor. As a result, productivity growth is vastly understated. Each year, when rates are adjusted, they are under corrected and the over earnings reappear. Using an interstate productivity factor, based on the FCC methodology, would raise the productivity factor to 10.2%, resulting in reductions of $.9 billion in cost recovery. Reinitializing the rates for underestimated productivity in the past 3 years would reduce costs recovery by another $2.9 billion.

EXHIBIT 2
OVER RECOVERY OF COSTS IN THE FEDERAL JURISDICTION
(Incremental, New Money)




The FCC uses a return on investment of 11.25 percent. Just getting the local exchange companies back to that level would lower cost recovery by $2.6 billion. Lowering the return to more reasonable levels would yield even larger reductions of cost recovery.

Some of the reductions identified in Exhibit 2 interact, so one cannot simply sum them to a grand total. However, the proposed reduction needed to "pay for" the restructuring is $4 billion in the first year, which could be easily accounted for by aggressive reductions in one category or moderate use of all three.

Although the FCC has routinely used any scheduled reductions in cost recovery to lower the switching rates, all of these sources of over recovery of costs apply to both loop costs and switching costs. A major source of the discrepancy between the regulated books and the financial books stems from the write off of loop costs. Loop costs have been falling because of the adoption of digital line carrier technology. Average loop costs have also been falling because of the growth of second lines, which are far lower in cost than first lines. The FCC's forward-looking cost methodology concludes that efficient loop costs would be far lower than claimed embedded loop costs.

The consumer proposal splits the reductions equally between fixed charges (PICC +SLC = $3.80 billion) and access (switched + special = $3.94).

## ANALYSIS OF FORWARD LOOKING COSTS AND RATES FOR UNBUNDLED NETWORK ELEMENTS DEMONSTRATES THAT THE CONSUMER PROPOSAL IS JUST AND REASONABLE

Not only does the consumer proposal fit squarely within the regulatory cost recovery proceedings at the FCC, it is also consistent with the economic policy that the commission has set, as CFA, CU and TXOPC stated in their comments in response to the CALLS proposal. Forward-looking economic costs require a reduction of recovery of loop costs in the federal jurisdiction.

The FCC has recently used its Synthesis Proxy Cost Model (SPCM) to calculate the high cost payments for large LECs. States have begun using forward-looking economic costs to set Unbundled Network Element rates. CALLS defines the reductions in switching costs as movement to forward looking economic levels. A few examples of how these numbers compare are provided below.

As noted in the TXOPC, CFA, CU comments, we must also look forward a bit. That is, the growth of second lines is dramatically lowering costs. In part, this is why there is this constant over recovery of costs in the Federal jurisdiction. Since CALLS points to 2004 as the end point, the result must be reasonable at that point in time.

National average forward looking costs are just over $20.00 based on 1996 numbers (see Exhibit 3). TXOPC, CFA, CU have demonstrated that the growth of second lines has likely already driven costs down by $1.00 to $1.50 due to the growth of second lines. They will certainly fall another $1.50 by 2004. Thus, by 2004, national average loop costs should be in the neighborhood of $17 per month.

Although Unbundeld Network Element (UNE) rates are not available on a national average basis, examination of these rates on a state-by-state basis indicate that they have been set in the same range as the cost estimates generated by the SPCM. A few examples demonstrate the point.

UNE rates in Texas are $18.36 for Southwestern Bell Telephone Company (SWBT). Forward-looking costs in Texas are $19.07 for SWBT. The statewide average for all loops in Texas (for all companies covered in the FCC support analysis) is $21.38. With second line growth this number would fall into the range of $15 to $18.

We obtain similar results for Virginia and Delaware for UNEs. In comments in this proceeding TXOPC, CFA, CU demonstrated similar outcomes for other states with the SPCM results.

EXHIBIT 3

USE OF FORWARD LOOKING ECONOMIC COST, AS RECENTLY APPLIED FOR HIGH COST SUPPORT AND STATE UNBUNDLED NETWORK ELEMENT RATES REQUIRES REDUCTION OF LOOP COST RECOVERY IN THE FEDERAL JURISDICTION

| | BELL RATES/COST | | ALL COMPANIES FCC-SPCM | | |
|---|---|---|---|---|---|
| | FCC-SPCM 96 SUPPORT | PUC-UNE RATES | FCC-96 | | 2004 ESTIMATED |
| NATIONAL AVG. | | | 20.14 | → | 17.00 |
| TEXAS | | | | | |
| Highest Density Zone | | 16.35 | | | |
| Middle " " | | 17.86 | | | |
| Lowest " " | | 23.19 | | | |
| Statewide | 19.07 | 18.36 | 21.38 | → | 18.38 |
| DELAWARE | | | | | |
| Zone 1 | | 12.95 | | | |
| Zone 2 | | 16.01 | | | |
| Zone 3 | | 19.55 | | | |
| Statewide | 18.96 | NA | 18.96 | → | 15.96 |
| VIRGINIA | | | | | |
| Zone 1 | | 12.04 | | | |
| Zone 2 | | 17.75 | | | |
| Zone 3 | | 30.78 | | | |
| Statewide | 19.17 | NA | 22.92 | → | 19.92 |

The consumer proposal would envision cost recovery for loop in the year 2004 that is generally described in Exhibit 4. Our proposal supports national average loop costs without implicit subsidies, in the range of $20, assuming that the federal share of costs is 25 percent of the loop. This is consistent with the forward-looking costs used by the FCC and the UNE rates adopted by the states.

Our proposal, which supports loop costs up to $20, actually leaves a little money on the table, since we believe that national average loop costs will be down to $17 by then. CALLS, on the other hand, drives up the costs supported by federal charges to almost $25. CALLS claims a national average SLC of $6.15, which supports total costs of $24.60. It adds in a universal service fund of $650 million (equal to about $.32). Thus, by the time CALLS is through, the institutionalized over recovery of cost will be 50 percent (~ $25/$17= 1.47).

EXHIBIT 4
LOOP COST RECOVERY IN THE FEDERAL JURISDICTION
AT THE END OF THE TRANSITION IN 2004
UNDER THE CONSUMER PROPOSAL

| | | |
|---|---|---|
| RESIDENTIAL CONSUMER (AVG. 1ST & 2ND LINE SLC)<br>(Assumes 1/3 of all lines are second lines in 2004) | $3.30 | |
| BUSINESS CONSUMER (SLC) | 5.00 | |
| AVG. RES/BUS SLC<br>(Assumes 1/3 of all lines are Bus) | | 4.00 |
| PICC (NOT ON BILL) | | .50 |
| HIGH COST SUPPORT<br>($1 billion) | | .50 |
| DSL COST RECOVERY | | + |
| TOTAL COST RECOVERY | | 5.00+ |
| TOTAL LOOP COSTS SUPPORTED<br>(Assuming 25% Cost Recovery In Federal Jurisdiction) | | 20.00+ |

## CONCLUSION

Implementation of the consumer proposal will go a long way towards resolving many of the cost issues facing the Commission. Additionally, adoption of the consumer group proposal will assist both long-distance and local service carriers by correcting some of the existing imbalances in federal cost recovery and access charge collection. Most importantly, however, is the fact that this proposal will provide consumers with real, clearly identifiable benefits in the form of lower costs.